

Revenue-Supported Rating Criteria

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Related Research

Applicable Criteria

- *Dual-Party Pay Criteria For Long-Term Ratings on LOC-Supported U.S. Public Finance Bonds, March 10, 2011*
- *Criteria for Assigning Short-Term Ratings Based on Internal Liquidity, June 20, 2011*
- *Rating U.S. Municipal Short-Term Debt, Dec. 23, 2010*

This report replaces the previous report of the same title dated Oct. 8, 2010.

Summary

This report presents Fitch Ratings' criteria for assigning credit ratings to revenue-supported obligations and entities in the public finance sector. It discusses the key qualitative and quantitative factors that influence a borrower's expected ability to meet financial obligations in full and on schedule. The criteria are organized into four broad categories of analytical focus: governance and management; operational profile; debt profile; and financial profile.

While the report describes Fitch's general approach for assigning revenue-supported ratings, Fitch notes that not all the credit factors discussed may pertain to every rating situation. Public finance borrowers that issue revenue-supported debt represent an extremely diverse set of organizations that include municipal enterprises, educational and cultural institutions, nonprofit hospitals, and cooperative utilities. Even among entities of similar size, scope, and purpose, these businesses are predominantly localized enterprises, each of whose creditworthiness is tightly linked to local demographic, economic, political, and/or competitive characteristics. As a result, the degree to which certain credit factors are emphasized — especially nonfinancial factors — will vary depending on the levels of credit stability and competitiveness observed within the sector and for individual borrowers. Each specific rating action commentary or rating report will discuss those factors most relevant to the individual rating action. The purpose of this report is to outline the most common overlapping credit factors for the various types of revenue-supported entities. For more guidance on the application of the rating factors discussed in this report, please refer to Fitch's sector-specific rating criteria.

Governance and Management

The effectiveness of governance and management is an important factor in assessing an organization's creditworthiness, as management's decisions and initiatives — subject to the oversight and strategic direction of the governing body (such as a board of trustees or city council) — can ultimately determine the entity's long-term financial viability. Fitch will generally limit its report comments on management and governance to instances where their effectiveness materially influences the rating decision.

Governance

With a level of analysis tailored to the structural characteristics of the sector, Fitch reviews the effectiveness of the governing body in establishing and implementing its policies and principles. Fitch's assessment may involve developing an understanding of the governing body's mission and strategy, structure, composition, interaction with management, knowledge of industry issues, and performance standards.

Management

Fitch also examines the track record of senior administration in implementing the governing body's policies and providing capable day-to-day management. Fitch's analysis is qualitative in nature and looks to the senior staff's history of successfully meeting the goals defined in a strategic plan and its ability and willingness to make tough decisions in the face of a changeable operating environment. While a failure to meet specific goals may not be viewed negatively in all cases, Fitch expects management to explain significant deviations from planned, expected, or budgeted results.

Management effectiveness may also be judged through a review of the planning processes and management structures. Management teams that articulate a strong understanding of their markets and capabilities and that are organized and operate consistent with industry best practices are viewed more favorably.

Operating Profile

Fitch's rating methodology includes a review of the operating characteristics of a borrower. Measured in a variety of ways depending on the borrower's sector, Fitch's operations review may include investigations of business strategy, operational effectiveness, environmental factors that can affect creditworthiness, and capital planning and management processes. Core to this analysis is an examination of internal processes and procedures designed to maximize asset productivity and a review of an organization's ability to maintain operating strength in a variety of economic and business conditions. Fitch views favorably those organizations that demonstrate stability in their performance level over time.

Business Strategy

To assess business strategy, Fitch examines an organization's position within the markets served and ability to meet the needs of its constituents. While Fitch reviews historical market position trends in the context of current industry characteristics, close attention is paid to the flexibility an organization retains to deal with potential changes in its competitive or operating landscape.

Fitch looks to overall trends in demand and financial metrics to judge the effectiveness of an organization's business strategy. As part of the analysis, Fitch reviews the institutionalized processes that facilitate effective strategic planning, with an emphasis on aspects that provide operating flexibility to adjust for variations in demand. Even within the same industry, Fitch recognizes that no single business strategy is appropriate for all organizations. The plan should fit the mission of the issuer and the needs of its customers and other constituents. The ability of management to articulate a business strategy that demonstrates a thorough understanding of the operating environment and the borrower's strengths and weaknesses is an important credit factor for a strong investment-grade rating.

Operational Effectiveness

The efficient employment of capital assets to generate surplus funds to cover debt service requirements and ongoing repair and replacement of assets is a key credit consideration for all revenue-supported sectors. Fitch examines the productivity or utilization levels of existing physical plant assets in the context of a borrower's industry. Borrowers with elevated excess capacity and limited means to recoup their fixed costs are viewed negatively. While growth prospects and assumptions are carefully considered as part of a proposed expansion, Fitch may negatively view such plans when excess capacity or organizational inefficiencies have historically plagued an issuer's operation.

An organization's ability to generate resources from its operations sufficient to fund capital renewal and expansion and service debt obligations is evaluated through an analysis of revenue and expense trends. Changes in revenue are analyzed by reviewing an organization's pricing strategies; regulatory, political, or market limitations on its ability to influence price levels; and volume or demand patterns. An organization's expense structure is similarly reviewed, with additional consideration given to cost containment efforts and industry-specific factors that may affect the cost and availability of inputs, whether raw materials, supplies, or labor, going forward.

Environmental Profile

In sectors where marketplace competition is a potential rating concern, an organization's position relative to its peers is a major area of analytical focus. In such cases, Fitch's analysis may include reviews of market share trends, rate competitiveness, industry reputation, geographic coverage or footprint, and product differentiation. Aspirations to achieve higher industry standing or ranking, support service area economic development, or significantly change market share concentration are evaluated in conjunction with the practical realities of the organization's current competencies and ability to secure additional resources to fund such initiatives.

Regulatory Issues

For sectors subject to external regulation, Fitch combines a review of the current and expected regulatory climate with an assessment of the organization's ability to maintain stable operations in the face of regulatory change. Fitch may review responses to prior regulatory mandates, identifying financial and operational effects. Fitch examines the potential for future regulatory initiatives and assesses whether the organization, through its systems, practices, and resources, will have the ability to manage potential downside risks. In sectors where external regulation is prevalent and has a bearing on creditworthiness, organizations that are proactive in responding to regulatory developments and that participate effectively in the regulatory and legislative processes help to support solid investment-grade ratings.

Capital Planning and Management

Fitch assesses the feasibility of significant investment in physical plant capacity by reviewing the issuer's master facilities plan (MFP) or capital improvement plan (CIP). Plans that are dynamic, address facilities needs over multiple time spans, and specify funding sources are viewed more credibly in the rating process. In general, modular MFPs are viewed more favorably by Fitch because they provide an organization the flexibility to modify its planned capital investment should business or market conditions prove unfavorable. Fitch's review focuses on current capacity constraints and limitations, the assumptions that underlie volume projections, and the capital budgeting process. In addition, funding sources, which may include a combination of debt proceeds, cash on hand, governmental appropriation, and other sources, are reviewed for reasonableness. For sectors that have large CIPs, the construction contract may be evaluated to assess the overall terms and provisions (such as liquidated damages, early completion incentives, and labor contracts and cost adjustments).

Fitch reviews an organization's process for and financial ability to make annual routine investment in asset maintenance and equipment acquisition. The amount of deferred maintenance an organization has will be assessed in the context of its physical plant size and the plan for addressing the most critical needs.

Debt Profile

The level and structure of a borrower's debt strongly affects Fitch's overall assessment of creditworthiness. The purpose of a planned financing, the total amount of debt outstanding, and various characteristics of a borrower's debt structure are all components of Fitch's review. Fitch's approach may also consider the realization of low likelihood but high consequence debt market dislocations and a borrower's ability to meet obligations under such stressed conditions.

Purpose

Fitch's debt profile analysis begins with a review of the rationale to issue debt. For new money issues, Fitch seeks to determine if planned capital investments are justified by

capacity constraints, projected market growth, or competitive opportunities. In addition to Fitch's own research and analysis, Fitch considers issuers' methods to monitor industry growth patterns and their relative market position, if appropriate, in addition to conducting its own analysis of these factors. Fitch looks favorably on organizations that soundly demonstrate a need for their CIP by employing a variety of techniques to assess service area dynamics, such as econometric analysis and consultations with regional economic development and planning agencies and local businesses, as well as timely economic research and valid surveys. Fitch is specifically interested in the most significant variables that affect increases and decreases in demand for an organization's goods and/or services.

A borrower's ability to service planned debt from existing operations is a credit strength. However, if debt repayment depends on the incremental revenue to be generated by new capital assets, the evaluation of project completion risk becomes an important aspect of Fitch's analysis.

When debt is issued to refinance or restructure existing obligations, Fitch's analysis focuses on the rationale for the issuance and the options available to the issuer for the purpose.

Magnitude

Fitch evaluates the actual and expected amount of debt outstanding by comparing debt and debt service levels to a comparable group of issuers and examining future debt service requirements in relation to historical and expected revenue streams and the borrower's overall cost structure. Ratios relevant to the sector capture the financial flexibility afforded by an organization's assets and operations relative to outstanding and expected long-term debt.

The inability to meet periodic debt service requirements with operating cash flows is, in most cases, viewed negatively. However, in certain cases, these concerns may be mitigated when a borrower's non-operating revenues (or those of an affiliate or other related entity that support the borrower) show a long and stable history or its liquid assets are several times greater than debt obligations (particularly for healthcare systems). Investment-grade ratings generally require coverage of debt service by earnings before capital costs, with higher ratings correlating strongly with higher coverage ratios. However, the presence of extraordinary pricing flexibility or available liquidity can mitigate occasional deficiencies in coverage.

Structure

The characteristics of a borrower's planned and existing debt obligations have a strong bearing on Fitch's assessment of creditworthiness. The establishment and composition of the obligated entity or entities, the nature of the security pledge, interest rate mechanisms, demand features, performance covenants, and principal amortization are all components of Fitch's review.

Fixed-rate bonds with amortizing principal within the assets' expected life provide the most stable debt configuration, and a high proportion of fixed-rate debt is viewed positively. For borrowers that use variable-rate debt, Fitch examines their ability to manage interest rate and liquidity risk and considers mitigating factors, such as cash or hedges, that can reduce the risks involved. Generally, issuers that cannot absorb interest rate spikes or handle failed remarketings without materially damaging their overall financial profile are viewed negatively.

While most variable-rate demand bonds are supported by dedicated liquidity facilities provided by financial institutions, highly rated borrowers sometimes act as their own liquidity providers, allowing them to avoid bank liquidity fees and potentially restrictive

legal covenants. In such instances, Fitch's analysis considers the stability and availability of funds sufficient to meet bond purchase requirements, as well as the policies and procedures that would be followed should a failed remarketing occur.

The amount of variable-rate debt an issuer can manage (hedged or not) is a function of its operating risk profile, quality of cash flows, amount of available funds, and ability to manage interest rate exposure and financial hedges. To determine if an issuer can manage its variable-rate and short-term debt exposure at its given rating level, Fitch may perform stress tests to determine the resilience of an issuer's financial metrics (e.g. cash flow and liquidity adequacy), compared with its peer group. Typically, higher-rated issuers in the 'A' and 'AA' categories are better able to take on a greater percentage of variable-rate debt, compared with lower-rated issuers.

Fitch's analysis also includes a review of the borrower's use of financial derivatives, or swaps. Where swaps exposure is significant, credit concerns can be offset in the rating process by an effective oversight function, counterparty diversification, and demonstration of a clear understanding on the part of management and governance of the benefits and risks involved.

Legal Provisions

Fitch analyzes several legal factors, which may include indenture provisions such as security pledges, rate covenants, events of default, additional bonds tests, reserve requirements, and bank bond provisions for variable-rate demand debt. While Fitch believes that bond covenants are clearly important to overall investor security, the degree to which they influence ratings varies. For most borrowers with ratings in the 'A' category or higher, operating performance will have a greater effect on the rating than legal provisions. However, the lower an issuer's rating, the more important legal provisions may be to the final rating, with weak security provisions resulting in lower ratings than those of similar borrowers whose debt reflects stronger security provisions.

Bank Bond Ratings

In conjunction with or subsequent to a borrower's issuance of variable-rate demand bonds, Fitch may be asked to assign a long-term rating to the borrower's corresponding bank bonds, i.e. variable-rate demand bonds that have been tendered and not remarketed, and then purchased by the liquidity provider in accordance with the liquidity support agreement. Fitch bases this rating on its analysis of the underlying credit strength of the issue, taking into consideration the potential negative effects of a purchase of the bonds by the bank, which may include a ramp-up in interest rate and an accelerated repayment of principal. Since these factors are considered in Fitch's analysis of the underlying rating of all parity debt, including any variable-rate demand obligations (VRDOs), bank bonds whose security is on parity with their corresponding VRDOs carry the same underlying long-term rating as those VRDOs. Similarly, an obligation arising from commercial paper being purchased by a liquidity provider would be assigned the same rating as the issuer's parity obligations.

Financial Profile

A borrower's overall financial profile contributes materially to the rating determination. Fitch's analysis includes quantitative assessments of operating performance, liquidity, and debt load, as well as the historical trends in such measures. Comparisons with entities similar to the borrower being rated are often a component of the analysis.

Fitch believes that the financial profile is a product of the qualitative and strategic factors previously discussed in this report and that the credit rating should be supported by well-founded expectations for such factors. Additionally, qualitative factors can often modulate

the risk level that may be indicated by a narrow review of financial metrics, contributing to additional credit strength or weakness. Finally, absent the development of a clear trend, a certain amount of variability in financial performance should not affect the rating on the bonds, as long as a borrower's underlying strategic position remains stable.

Performance Metrics

Both historical and projected financial results are considered. The best indicator of future financial performance is the recent track record of the borrower, its management team, and its market. If future performance is expected to track differently from historical results due to major project plans, environmental changes, or management initiatives, Fitch will examine the assumptions that drive projected results. Forecasts that rely on aggressive volume growth, market share capture, price increases, or expense reductions are viewed with analytical conservatism in the rating process. Fitch may request sensitivity analyses stressing major forecast assumptions to gauge their importance in achieving projected results.

Using audited and interim financial information and statistics, Fitch assesses the organization's financial profile, reviewing trends in operating performance and non-operating results, absolute and relative levels of balance sheet assets and liabilities, and statistical information relevant to the sector. Financial forecasts, if available, are included in Fitch's review.

An organization's ability to generate resources from its operations that are sufficient to fund capital renewal and comfortably meet expected debt service obligations is a key rating consideration. Demonstrated stability or consistent improvement is viewed positively. Where variability is observed, Fitch's analysis seeks to identify the reasons for such changes and management's response to internal and external factors that may have resulted in negative movements. Although Fitch's approach considers non-operating revenues, performance analysis emphasizes core operating results.

For sectors such as healthcare and education, whose credit characteristics call for relatively large cash reserves to support investment-grade ratings, the level of balance sheet assets held as cash, or that can be expeditiously converted to cash, is a key credit factor. Unrestricted cash and investments are measured absolutely and relative to operating performance and debt levels, whether such assets are used to quickly pursue market opportunities, counter market threats, absorb unexpected declines in operating performance, generate income to support operations, or simply serve as a backup reserve to meet debt service requirements. In such sectors, higher allocations of investments to equities and alternatives are viewed more negatively due to their potential for price volatility, lack of price transparency, and illiquidity.

The actual and expected debt a borrower carries — its amount, amortization, and servicing requirements — is a key component of the financial profile. While specific metrics vary depending on the sector, Fitch's analysis includes the computation of several ratios that describe the relative amount of debt used to capitalize the enterprise, the magnitude of debt service requirements in relation to the scope of the entity's operations, and the ability of operations to generate funds to meet debt service requirements.

Peer Comparisons

Fitch's analysis also considers how a borrower's financial profile matches up with the profiles of other entities with similar market, operational, financial, and credit characteristics. Depending on the sector, one or more analytical tools may be used to compare a borrower's actual or pro forma financial performance with peer group benchmarks or rating-specific median financial ratios.

Note on Sources

Fitch's analysis and rating decisions are based on relevant information available to its analysts. The sources of this information include the issuer and/or the obligor, the public domain, and, in the case of U.S. public finance, the financial advisor if a financial advisor has been engaged. This includes relevant, publicly available information on the issuer, such as financial statements and regulatory filings. The rating process may also incorporate information provided by other third-party sources. If this other third-party information is material to the rating, the specific rating action will disclose the relevant source.

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